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PASS TO TREASURY/IA: LUKAS KOHLER & JEFFREY BAKER

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SUBJECT: GOG IMPLEMENTS THIRD ROUND OF AUSTERITY MEASURES
IN AN EFFORT TO CONTAIN PUBLIC FINANCES AND BOOST
CONFIDENCE, BUT WILL THEY BE ENOUGH?

REF: A. ATHENS 339
¶B. ATHENS 216
¶C. ATHENS 176
¶D. 2008 ATHENS 1655
¶E. 2008 ATHENS 1515

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Summary

¶1. (SBU) In a move to boost market and EU confidence in the government's commitment and ability to contain public finances, the GoG on March 18 implemented a third series of measures to cut spending and boost revenues, including a wage freeze affecting approximately 70 percent of public sector employees and special, one-time taxes on high-income earners. The EU and various domestic and international economists had expressed skepticism that two previous rounds of GoG measures would have an appreciable impact on Greece's burgeoning deficit (which many economists believe could climb as high as 5 percent of GDP in 2009, even without a significant GoG stimulus package). While the new measures are certain to result in budgetary savings, given the GoG's unrealistic 2009 revenue and expenditure targets and recent increases in expenditures (see reftels B and C), it remains unlikely that they will be enough for the GoG to meet its deficit target (3.7 percent of GDP) and halt the reversal of the downward trend in public debt (projected by the GoG to increase for the first time in several years from 94.6 percent of GDP in 2008 to 96.3 percent in 2009).

¶2. (SBU) Furthermore, it remains unclear whether the move will have the desired effect of building market confidence and thereby decreasing the spread on yields between Greek and German ten-year bonds (currently hovering at around 270 basis points). As for the EU, Luxembourg Prime and Finance Minister and the head of the Eurozone group of finance ministers, Jean-Claude Juncker, over the weekend commended the GoG for the measures but emphasized the government must do more to cut its budget deficit in 2009 and to "undertake a thorough restructuring of the economy." What may be clearer is that the wage freeze will further dampen public support for Prime Minister Karamanlis' government, which steadily has been losing ground in opinion polls to opposition PASOK. Public servants have vowed to unite in solidarity against the GoG's measures by participating in a general strike already called for on April 2. Outraged public servants and high-income earners, a one-seat majority in Parliament, and the opposition PASOK party with a roughly 4 percent lead in

public polling does not seem to be a recommended cocktail for winning hearts and minds. End Summary.

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Measures, on Top of Measures, on Top of More Measures
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¶3. (U) On March 18, the Karamanlis government implemented a third round of austerity measures aimed at reining in public spending. This time, the government hit two areas that public pundits had decreed a third rail in the event Karamanlis wanted to call early elections this spring: a freeze on public wages and special, one-time taxes on high-income earners. Indeed, in 12-13 March meetings, Secretary General for Finance Ioannis Sidiropoulos and Secretary General for Fiscal Policy Ioulia Armagou told EconOff and U.S. Treasury representatives, Jeff Baker and Lukas Kohler, that public sector wage freezes were not on the table at this time. The new measures announced by Minister of Finance Papathanasiou include:

(a) A freeze on salaries of public sector employees and pensioners earning more than 1,700 euros/month (estimated to affect approximately 70 percent of civil servants -- which make up about 22 percent of Greece's labor force -- and 50 percent of civil service retirees);

(b) A one-off tax levy in 2009 of 1,000 euros for those with incomes over 60,000 and up to 80,000 euros; 2,000 euros for incomes ranging from 80,000 to 100,000 euros; 3,000 euros for incomes ranging from 100,000 to 150,000 euros; and 4,000 euros for those with incomes over 150,000 euros/year (based on tax declarations, this will affect about 128,000 Greek taxpayers);

(c) A cap of 12,000 on new hires in the public sector this year (despite 21,500 civil servant retirees last year), all of whom will receive lower salaries and fewer benefits; and

(d) A symbolic 5 percent tax hike for members of Parliament.

At the same time, in order to support those with lower incomes, the GoG announced:

(a) A one-off bonus of 300 euros for public servants earning between 1,500 and 1,700 euros/year and public service retirees earning between 800 and 1,000 euros/month (estimated to affect 10 percent of civil service and 20 percent of civil service pensioners); and

(b) A one-off bonus of 500 euros for public servants earning less than 1,500 euros/month and civil service pensioners earning monthly pensions less than 800 euros/month (estimated to affect 20 percent of civil servants and 30 percent of civil service pensioners).

¶4. (U) The GoG resorted to these unpopular measures because two previous rounds of budget austerity measures had not had the desired effect of increasing confidence in the GoG's budget program. The first round of measures, announced in early February, included some 350 million euros in higher cigarette and alcohol taxes, a 500 million euros cut in discretionary spending (e.g., cuts in civil servant travel budgets, etc.), as well as measures to cut waste at state-owned companies and hospital. (Note: This set of measures was accompanied by an updated Stability and Growth Program, or SGP, that revised the wildly optimistic targets projected in the 2009 budget passed by Parliament in December (see reftel D). In the update, GDP growth for 2009 was revised down from 2.7 percent of GDP to 1.1 percent, and the budget deficit was revised up from 2 percent of GDP to 3.7 percent (see reftel B). End Note.) Despite the revised

targets and the initial measures, the European Commission (EC), international and domestic economists, and the markets continued to express severe doubt in the GoG's ability to control public finances and achieve its new targets. For its part, in mid-February, the EC commenced the Excessive Deficit Procedure (EDP) against Greece for breaching the 3 percent cap of the budget deficit. In response, in late February, the GoG announced a second set of measures aimed at reducing the deficit, including a 10 percent reduction in ministerial discretionary spending (estimated to be only 14 percent of the GoG budget), a ceiling on executives' salaries in state-owned companies, a limitation on the board size of state-owned companies, a reduction of the "costs of bureaucracy" by 25 percent, and "enhanced controls" against tax evasion. (Note: The cut in discretionary spending in the second package of measures is the same action addressed in the first set, and which the GoG estimates will result in savings worth 500 million euros. End Note.)

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Impact on the Budget & Fiscal Deficit: Clear as Mud
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¶5. (SBU) It is difficult to say what the actual impact of all these measures will be on the budget and on the fiscal deficit, given that the GoG ha not revised the actual 2009 budget submitted to and passed by Parliament in December 2008 (see reftel D). That budget forecast revenues at 64.2 billion euros and expenditures at 66 billion euros (with a 2.0 percent general government budget defiit). Optimistic to begin with, with a revised budget deficit of 3.7 percent and three sets of cost-savings measures implemented since the December budget passed, these numbers clearly are no longer accurate. According to government estimates, the various measures will esult in the following budgetary savings or additional revenues:

(a) Savings/revenues from first set of measures: at least 350 million euros (new taxes).
(b) Savings/revenues from second set of measures: at least 500 million euros (from the discretionary spending cuts).
(c) Savings/revenues from third set of measures: between 650 million t 850 million euros (both taxes and wage freeze).

The MoEF believes that savings and revenues will be higher, since some of their measures target improved tax collection and efficiency gains from improved government operations. Given the GoG track record in these areas and the fact that the GoG does not appear to back up its new measures with teeth, the savings/revenues from these types of actions seem far less quantifiable and achievable. For example, the GoG expects it will receive an extra 1.8 billion euros in tax revenues from settlement of debts due the state. But this sum originally was supposed to have been collected in 2008, and the GoG does not appear to have put in place any measures that make its collection more likely in 2009. Also, regarding the 10 percent cut in discretionary spending (to yield 500 million euros in savings), the GoG has no system in place in ensure this occurs or penalty in the event it does not. (Note: During a March 13 meeting with EconOff and U.S. Treasury representatives, MoEF SecGen Armagou indicated that the only measure taken by the GoG to ensure this cut is affected is a letter from the Minister of Finance to his fellow Ministers. Furthermore, Armagou indicated that currently, the GoG has no way to force Ministries to stick to their original budgets, let alone enforce the envisaged cuts. End Note.)

¶6. (SBU) Moreover, the December numbers also do not reflect additional costs to the budget of recent GoG measures to support pensioners, the unemployed, and the vulnerable (see reftels B and C), including the one-off bonuses outlined above. The National Bank of Greece (NBG), Greece's largest

private bank, estimates the total sum of government support measures to date at well over 2 billion euros, or approximately 1 percent of GDP.

¶7. (SBU) More clear than the impact of the measures on the fiscal deficit is that the GoG's growth forecast of 1.1 percent of GDP (or 0.5 percent in their worst case scenario) continues to be irreconcilable with the realities of the global downturn. (Note: SecGen Armagou told EconOff and U.S. Treasury reps that the GoG forecasts 3.7 percent for the fiscal deficit whether GDP growth is 1.1. percent or 0.5 percent (the GoG's current worst case scenario). End Note.) Given that the Eurozone's growth forecast has been downgraded across the board to -2.6 percent, it is becoming more likely that Greece's growth will be closer to zero or slightly negative in 2009. Major downturns are expected in 2009 in Greece's key GDP drivers (tourism, shipping, and construction). In addition, according to both Sidiropoulos and Armagou, the government had been counting on consumption (largely driven by healthy public sector wage increases on the order of 8-9 percent) to help maintain GDP growth in ¶2009. The recent wage freeze will put a dent in this expectation, adding another drag to GDP growth. In light of more realistic GDP growth forecasts (0 percent to -1.0 percent), the fiscal deficit is more likely to fall in the range of -4 to -6 percent of GDP.

The EU and Markets: Thanks But We Need More!

¶8. (SBU) Despite the recent measures, the EU continues to urge Greece to do more to improve its finances. Luxembourg Prime and Finance Minister and the head of the Eurozone group of finance ministers, Jean-Claude Juncker, on March 22 emphasized the government must do more to cut its budget deficit in 2009 and to "undertake a thorough restructuring of the economy." When the EC announced in mid-February that it was commencing the EDP process against Greece, it pointed out that Greece's excess over the 3 percent fiscal deficit cap is not a temporary response to the global crisis, but rather a failure to undertake sufficient fiscal consolidation efforts when economic conditions were more favorable. In a stern message, the Commission pointed out that Greece's fiscal imbalances are rooted in "insufficient control of public expenditures, overoptimistic revenue projections and structural and endemic problems related to the recording of Greek government accounts." Measures the EU and Bank of Greece (Greece's central bank) Governor George Provopoulos have strongly recommended the GoG undertake include:

(a) implementing permanent measures to curb expenditures, including a prudent public sector wage policy (i.e. one that keeps wage growth at or near inflation

expectations but below productivity gains), thereby contributing to a reduction in the debt-to-GDP ratio;

(b) ensuring fiscal consolidation has the goals of enhancing the quality of public finances and addressing external imbalances;

(c) implementing reforms to make tax administration and the budgetary process transparent and subject to mechanisms that monitor, control, and improve expenditure efficiency; and

(d) implementing further reforms of the pension and healthcare systems, with an eye towards making them sustainable in the long-term.

In short, the EU is not impressed with the GoG's limited adjustment measures thus far and wants to see more actions that both contain public finances in 2009 and put Greece on the path of long-term sustainability. The only question

remaining now is the deadline Greece will be given by which to bring its fiscal deficit under the 3 percent cap: 2010 or ¶2011.

¶9. (SBU) If the spreads between Greek sovereign 10-year bonds and German bunds are a proxy for the market's reaction to the GoG's measures, then it would appear the actions fell on deaf ears. While spreads likely reflect more than just the market's views of Greece (i.e. some portion is due to general high risk aversion, and some is due to desire for more liquid instruments as reflected in lower spreads), Greek spreads continue to hover around 260-70 basis points, with very little narrowing observed following the GoG's announcement. It may be that as with the EU, markets want more concrete and long-term actions, as well as more realistic forecasts by the GoG. (Note: Senior economists and bank officials at Eurobank, Alphabank, and NBG uniformly noted to EconOff and visiting Treasury representatives on March 12 that a key action the GOG could take to boost their confidence in the GoG's commitment to containing public finances was to freeze public wages. End Note.)

. . . And the Opposition Says . . .

¶10. (SBU) George Papandreou, the leader of opposition PASOK, moved quickly to undercut the GoG's claims that the wage freeze and tax hikes are evidence of fiscal responsibility, given the political cost. Papandreou argues that Greece needs more flexibility under the Stability Pact, but at the same time, he claims that if PASOK was in power, he would increase taxes on the wealthy and on banks in order to narrow the fiscal deficit. These comments seem to highlight that he has no better plan than the GoG to put Greece's public finances in order.

Comment

¶11. (SBU) It is clear that the GoG has not fully come to terms with the likely impact of the crisis on Greek growth and the fiscal deficit. As Financial Times International Affairs Editor Quentin Peel put it to Nobel-prize winning economist Paul Krugman during a March 18 panel discussion in Athens on the global financial crisis and its impact on the Greek economy: "I told you Paul, these people are in denial!" Despite expected sharp downturns in shipping and tourism (which combined make up approximately 25 percent of Greece's GDP), increasing negative growth forecasts in the EU and Eurozone (to which Greece exports approximately 50 percent of its goods and services), the government is planning for positive growth and limiting its adjustments to achieve its fiscal deficit target of 3.7 percent of GDP. The government seems to think hat because Greece has had higher than EU-average growth the past few years and because its banks had no exposure to "toxic debt," the Greek economy is inured from the global slowdown. It is not clear when and if reality will pervade, but the GoG's current strategy of throwing out a bone here and there will only succeed in wasting time and narrowing the GoG's policy choices. The longer the GoG waits to affect substantive reforms that win over both the EU and the markets, the more drastic the austerity measures it eventually will need to adopt. After

all, the impact of the criss on Greece's real economy will only become mre evident (not to mention worse) during the course of the year. And the longer its takesthe GoG to act, the more time it will add ontoits eventual recovery path, given the structual constraints the Greek economy already faces.

¶12. (SBU) Nonetheless, it is a very positive sign that the GoG implemented a public sector wage freeze. During the

March 18 conference on the global financial crisis, Paul Krugman noted for the audience that a key reform the GoG needed to undertake was to contain its real wage growth in order to become more compeitive vis-a-vis its trading partners. If this freeze can be incorporated into a broader wage policy, the GoG may have the seeds of a broader reform program. But economics aside, the Karamanlis government's action has not been well received by the public, which is using the action to build support for the next general strike on April 2. While the fact that the government implemented such a vilified reform may be a sign that it is getting more realistic, its failure once again to create public consensus prior to the implementation of a much-needed reform does not bode well for the popularity of the Karamanlis government, which has been roughly four percentage points behind opposition PASOK in polling for the last several months. End Comment.
McCarthy